Trends of international portfolio investment flows in EU member states from Southast Europe: To where does the money flow?

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TRENDS OF INTERNATIONAL PORTFOLIO INVESTMENT FLOWS IN EU MEMBER-STATES FROM SOUTHEAST EUROPE: TO WHERE DOES THE MONEY FLOW? [1]

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Abstract

In the present article we study a trend that has been observed in recent years - financial resources that could be invested in the development of "catching up" EU Member States in Southeast Europe are actually invested abroad, and support already developed economies, particularly in the euro area. We find that such a trend is likely to continue in the short to medium run due to weaknesses in the business environment and underdevelopment of local capital markets in Bulgaria, Croatia, Cyprus, Greece, and Romania. Therefore, we study the subsequent effects on the abovementioned economies and how the functioning of the Capital Markets Union (CMU) in the European Union could improve the channelling of the funding to the developing Member States. We conclude that the CMU initiatives have eased access to market-based financing and have widened the scope for entrepreneurs through the regulation of new forms of collective investment. However, these opportunities have so far been exploited to a minimal extent in the SEE region and no significant inflow of portfolio investment has been observed.

Keywords: financial markets, portfolio investment, capital flows, SEE countries, Capital Markets Union

Introduction

International capital flows attract the attention of economists, given the processes of globalization of the world economy. The volumes of these flows, their stability, and their direction, as well as the benefits and costs they bring to different countries justify the interest and are often the focus of researchers' attention.

However, international capital flows are not homogeneous. Foreign direct investment (FDI), foreign portfolio investment (FPI), and other types of investment are ultimately aggregated in a country's balance of payments, but they play different roles in the economic system. All types of foreign investment can be beneficial to a country's economic development, although various categories of investment have distinct characteristics and impacts.

Historically, FDI has been the more widely studied topic compared to FPI[4]. Although both types of investment are important in principle, FDI usually has a more direct and noticeable impact on economic development. It provides the host country with long-term commitments, technology transfer, job creation, infrastructure and workforce skills development that can promote sustainable economic growth. This makes them a critical area of study for economists, policy makers and analysts. Their importance is particularly high for countries

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[4] A detailed bibliometric study of research on the relationship between foreign direct investment and economic growth can be found in Xinxin et al. (2022).

that are at a lower stage of economic development. That is why the attention of the researchers that study the development of the Southeast European countries focuses primarily on the topic of inward FDI. The most frequently studied topics include the determinants of FDI inflows (Skuflic & Botric, 2006), the impact of FDI on economic growth and development (Apostolov, 2015), the role of institutional factors in attracting FDI (Bailey, 2018; Silajdzic & Mehic, 2022) and the effects of FDI on local firms and industries (Damijan et.al., 2013). The FDI outflows from Southeast Europe is not significant because the countries in this region are relatively small, the firms are not sufficiently developed and competitive for international markets, and firms have limited access to capital to finance international expansion. Therefore, the outflows of FDI from this region are not the subject of significant research interest.

FPIs, on the other hand, reflect trading of financial instruments. They contribute to liquidity, provide market funding opportunities for companies, and increase the efficiency of financial markets. A characteristic of capital flows in this case is that they can be significantly more volatile, susceptible to sudden changes and fluctuating in volume and direction. The relative importance of FDI and FPI may vary depending on a country's specific circumstances and priorities.. But ultimately, a balanced approach that combines both FDI and FPI can provide a more comprehensive and more successful economic development strategy.

In terms of such a balanced approach, this article analyses FPI flows to and from some Southeast European countries. The purpose of the analysis is to answer several questions. What are the net portfolio investment flows for these countries? Are they receiving more capital or more capital flows out of these countries through capital markets? Is there a common trend for the region and, if so, what is it due to? Is such a potential trend sustainable, and what might be its effects on local economies?

The discussion over the imposed questions is structured in the present article as follows: Initially, Section 1 reviews the literature on the role of portfolio investment in economic development. Particular attention is paid to publications concerning Eastern Europe. Section 2 presents the empirical evidence based on balance of payments data for the countries under review – Bulgaria, Croatia, Cyprus, Greece, and Romania. We find that relatively large volumes of capital are flowing out of the countries under consideration. In total, there was a net capital outflow of $75 billion for the period 2014-2022, with the private sector accounting for $111 billion of capital net outflows. Section 3 analyses the identified trends and seeks to explain the direction and size of portfolio investment flows and their effects on local economies. In this section, we consider the economic environment in the countries under review based on a number of macroeconomic indicators and other country characteristics. We argue that the tendency of capital outflow from the region is not due to the economic characteristics of the countries under consideration, but to the investment environment (in general sense) and the insufficient development of local capital markets. Section 4 discusses whether the identified trends are sustainable and what role the emerging Capital Markets Union can play. Our analysis shows that capital outflows from the region through portfolio investments can be expected to continue in the short to medium term. This trend can be moderated to some extent if countries manage to take advantage of the Capital Markets Union. But at this stage, this is not yet a reality. The last section presents the authors' conclusions.

1. Literature review. Why are portfolio investments important?

While banks are essential for financing economic growth, non-bank financial intermediation provides a relatively more powerful contribution to innovation and productivity-enhancing activities in today's complex economic systems (Kremer & Popov, 2018). Developed capital markets complement banks as a source of funding and thus also contribute to economic growth as well as to the greater flexibility and resilience of the financial system.

Several literature sources highlight the importance of portfolio investment in general and FPI in particular. For example, Bekaert et al. (2005) discuss the relationship between portfolio investment and economic growth. They find that portfolio investment positively affects economic growth by improving the development of financial markets and promoting resource allocation efficiency. Claessens & Rhee (1994) find that portfolio investment positively affects economic growth, especially in countries that have implemented financial liberalization reforms. Razin & Sadka (2007) examine the impact of portfolio investment on economic development, with a focus on emerging markets, and conclude that portfolio investment contributes to economic development by improving access to capital, promoting financial markets' development, and improving corporate governance. Beck et al. (2000) also examine the positive impact of portfolio investment, highlighting the role of institutional quality, risk factors and financial integration in determining the impact of portfolio investment on economic development.

The role of FPI has also received special attention in literature. Aizenman & Noy (2006) examine the relationship between FPI and economic growth in developing countries. They conclude that portfolio investment can positively affect economic growth through a variety of channels, including financing productive investment and the transfer of technology and managerial expertise. At the same time in a recent study for five African countries (South Africa, Botswana, Kenya, Mauritius, and Nigeria) Mlambo (2022) finds a weak relationship between portfolio investment and economic growth using quarterly panel data from 1995 to 2014.

From the point of view geographical allocation research has focused predominantly on Asian economies as regards their growth in recent years. Cooray & Josheski (2018) examine the relationship between portfolio investment and economic growth in South Asian countries. They show that portfolio investment positively affects economic growth by fostering financial markets' development, capital accumulation and technological progress. Tseng & Lin (2012) examine financial development in emerging Asian economies and conclude that FPI contributes positively to financial development by increasing liquidity, improving market efficiency, and promoting institutional development.

Other studies have focused on specific microeconomic effects. For example, the impact of FPI on firm-level performance in emerging markets has been studied by Alfaro et al. (2007). They argue that FPI positively affects firm performance and profitability, leading to economic progress. The limitations of portfolio investment are highlighted by Fostel & Kaminsky (2008) who show that FPI is concentrated in larger firms, which may limit the positive effects on economic development through small business growth.

On the other hand, Southeastern Europe is usually not considered as one region due to its heterogeneity in terms of economic development. Although not in large numbers, there are studies in the literature on portfolio investment flows in Central and Eastern Europe, where Greece and Cyprus are usually not included. But in most cases, the focus of research is on the short-term factors that influence these flows, and not so much on their stability over time and the implications of the presence or the lack of such stability for local economies.

The process of capital outflow from these countries is one of the characteristic features of their transition to a market economy and has been identified as early as the years between 1995 and 2005 (Brada, Kutan & Vukšić, 2008). The authors define this process as a primarily economic phenomenon, determined by differences in interest rates, investors' expectations of tax levels, inflation rates, the degree of control over capital flows and political stability. Peterle & Berk (2016) examine to what extent such processes differ between Central and Eastern European countries and developed EU countries based on initial public offering (IPO) cycles, using Deutsche Börse IPO activity as a base for comparison. In addition to macroeconomic fundamentals, investor attitudes are also found to be strongly influenced by risk aversion, the increase in pension fund assets and trading volumes in the market. Their research suggests that macroeconomic environment is a much stronger factor that limits investment as opposed to micro characteristics related to the specific financial state of the sectors of the economy or companies under consideration.

Albulescu (2015) reports the statistically significant effect of foreign direct and portfolio investment on economic growth in the long run over the period 2005-2012 in 13 Central and Eastern European countries. Another study (Stamenova, 2020), based on panel econometric analysis also for Central and Eastern European countries between 1999 and 2018, finds that portfolio investment flows depend most strongly on EU membership, exchange rate risk, public debt levels, and stock market capitalization. The level of domestic savings and consumption also matters, and they are strongly related to capital inflows and in particular portfolio investment flows according to Vilutiene & Dumciuviene (2020).

On the other hand, it is difficult to draw a generalized conclusion for the region, as there is considerable economic heterogeneity across countries with smaller markets that still offer advantages to global investors at substantial premiums (Baele, Bekaert & Schäfer, 2015). The same is valid also for the euro area countries where Luxembourg, Ireland, and the Netherlands are the most attractive Member States for foreign capitals (Beck et al., 2023). Although there might be significant benefits of investing in stock markets in Central and Eastern European countries, which stem more from geographic distribution than from the composition of investment portfolios, their returns vary dramatically over time, which is a major prerequisite for investing more cautiously in them (Middleton, Fifield & Power, 2008). However, a study of the same region shows that a reduction in the volatility of FPI is a precondition for a subsequent increase in FDI in the long run. The implication is that economies that progress in capital liberalization also benefit from increased FDI (Erzurumlu & Gozgor, 2014).

2. Is there a common pattern across countries? What are the facts?

The present article examines the portfolio investment inflows to and outflows from five countries in Southeast Europe that are members of the European Union. These are Bulgaria, Croatia, Cyprus, Greece, and Romania. The study deliberately does not include other Southeast European countries because our aim is to place the countries under review within the same institutional framework – the European Union. This is essential because portfolio investment flows depend heavily on existing legislation, regulations, and market infrastructure. The countries under consideration include those that are older EU members (Greece and Cyprus) and those that have relatively recently joined the Union (Bulgaria, Romania, and Croatia). Two of them are members of the euro area (Greece, Cyprus) and two of the other three (Croatia[5], Romania) have a floating exchange rate, while the third one (Bulgaria) is in a currency board arrangement.

The period covered by the analysis is 2014-2022[6]. The starting year is defined because of the end of the Great Recession (2008-2012), the accession of Croatia to the European Union (01.07.2013) and the financial crisis in Cyprus (2013). Our aim is to track financial flows in periods when they are not affected by temporary, exceptional circumstances.

Table A1[7] in the Appendix presents the size of inflows and outflows[8] for each of the countries studied. As can be seen, in most cases outflows exceed inflows. Over the 9-year period considered, the region experienced a net outflow of capital – the size of the aggregate outflow for all countries ($149.8 bil.) was twice the size of the inflow ($74.8 bil.). This substantial difference is not only the result of large investments abroad, but rather of a trend. This can be seen if one examines the dynamics by year, which is shown in Figure 1.

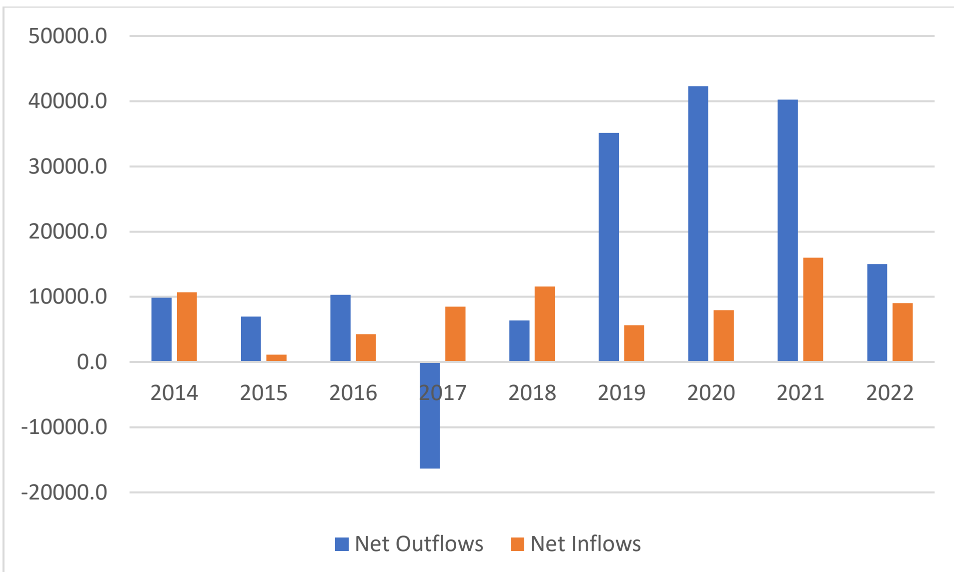

Fig. 1. Net foreign portfolio investment - total for selected countries (mil. $)
Data source: IMF, Balance of Payments

In six of the nine years of the period under review, capital outflows were larger than inflows, for one year (2014) the flows were similar in size, and for only two years (2017 and 2018) inflows were significantly larger than outflows. It should be noted that in 2017 Greek banks sold foreign debt securities for $40.1 bil. (net) and in 2018 they completed eight sales of foreign bank subsidiaries for a total book value of over $14 bil. The goal was to stabilize their balance sheets in the wake of the Greek debt crisis by reducing the large amount of non-performing loans[9]. These divestments, which reduce net outflows from Greece and hence

[5] Croatia becomes a member of the euro area on 01.01.2023.

[6] Official data for Croatia for 2022 is still missing.

[7] In all tables and graphs for the countries considered, negative outflows mean a decrease in foreign assets and negative inflows mean a decrease in liabilities to non-residents. Net flows are the difference between outflows and inflows.

[8] Financial flows include Equity and investment fund shares and Debt securities. Inflows result from incurrence of liabilities and outflows result from acquisition of financial assets. A negative sign for outflows means a decrease in foreign assets and a negative sign for inflows means a decrease in liabilities to non-residents.

[9] According to the Bank of Greece, Greek banks have managed to reduce the total volume of non-performing loans from their peak of €107.2 bil. in 2016 to €84.7 bil. at the end of 2018.

from the region, could be considered as one-off and atypical. If they are not accounted for, because of such consideration, the trend of capital flight from the region becomes even clearer[10].

Figure 2 shows the same picture, but from a different perspective, in terms of financial asset classes that are traded across borders[11]. Capital outflows through the portfolio investment channel are mainly due to debt assets that investors from the countries under consideration buy on international markets. Only in 2017, when Greek banks sold a large volume of foreign debt securities, the net outflow for the purchase of such assets was negative. The net outflow due to purchases of debt securities is either close to zero or substantially positive for the rest of the years. Figure 2 also shows that the outflow and inflow of equity are similar, yet for 2014 and 2018 the inflow is larger. This is due to the facts that in 2014 Greece managed to attract equity investments of $11.3 bil. and in 2018 Cyprus managed to attract more than $8.3 bil. These are atypical volumes for these two countries compared to other years, which gives us reason to consider the two years as exceptions from the overall dynamics.

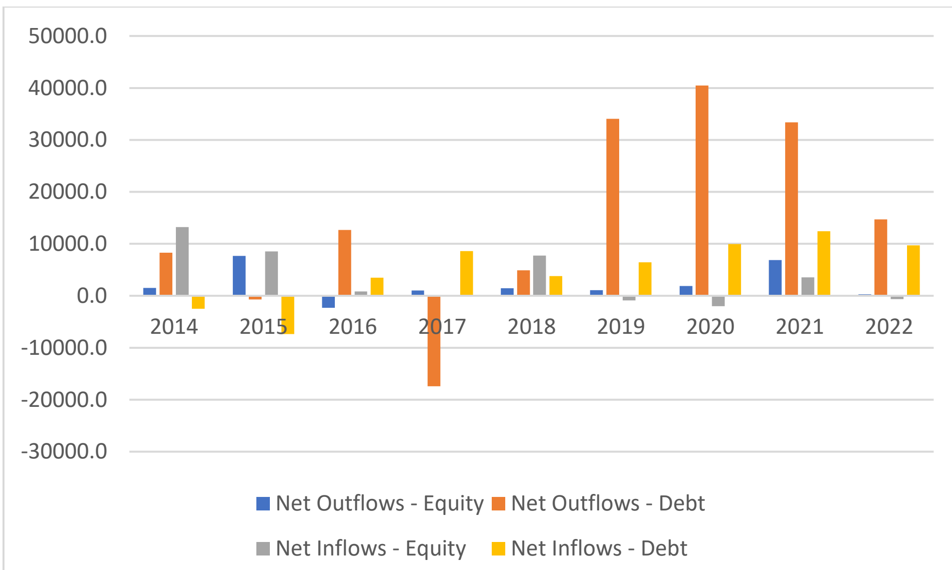

Fig. 2. Net foreign portfolio investment by asset classes, total for the selected countries, (mil. $)

Data source: IMF, Balance of Payments

Before proceeding with the overall picture, it is useful to clarify why we treat such equity investment volumes as atypical. On the one hand, it is the size of these investments – $11.3 bil. for Greece and $8.3 bil. for Cyprus, given that in the period under review the average annual inflow of equity investment for Greece was $2.3 bil. and for Cyprus it was $1.3 bil. On the other hand, there are atypical circumstances in these two countries during the period under review. For 2014, the situation in Greece is as follows: The economy is in a process of stabilization after the debt crisis, structural reforms and fiscal consolidation measures are being implemented, and the country is also receiving support from the European Union and

[10] If these sales are not accounted for, then 2018 would be registered a net outflow of $15.2 bil instead of a net inflow of $24.9 bil.

[11] Data from Table A3 in the Appendix.

international financial institutions. This helps the confidence in the Greek economy to be restored and the market sentiment to be changed. Investors' perception is that the financial crisis is over and that after significant falls in asset prices during the crisis, Greek equities are now attractive, especially in sectors expected to benefit from the economic recovery (tourism, shipping, food, real estate).

In addition to market sentiment and expectations, there are also factors arising from the country's economic situation. At that time, Greece embarked on an ambitious privatization program involving infrastructure projects, real estate, and utilities. The aim was to collect budget revenues by attracting both domestic and foreign investors.

Similar factors are valid for Cyprus. After the severe financial crisis (2013), the country undertook structural reforms, fiscal consolidation, and recapitalization of the banking sector. Like Greece, the country has initiated a major privatization program to sell state assets and increase private sector participation in various sectors, including energy, telecommunications, and transport. Moreover, significant reserves of natural gas have been discovered in the maritime economic zone of Cyprus, which is particularly attractive for foreign energy companies.

Also, to encourage foreign investment, Cyprus introduced various incentives and programs. These include the Cyprus Investment Program, which grants citizenship to individuals who invest a significant amount of money in the country[12]. In addition, the government implements specific measures to facilitate the opening of international business companies and attract foreign investment. This is coupled with an attractive tax system, including a relatively low corporate tax rate and several double taxation agreements allowing investors to optimize their tax liabilities.

The combination of these factors for Greece and Cyprus has played a role for attracting a relatively large volume of foreign portfolio equity investment particularly in 2014 and in 2018. However, it should be noted that the reported volumes for these years are atypical – nothing close to such volumes was observed before or after these years. This gives reason to believe that the influence of one-time factors, such as privatization or citizenship-for-investment programs, do not have a systematic impact over time.

The financial flows in Table A1 include government operations. In the countries studied, national governments often go to international markets and issue sovereign debt to finance government budget deficits. This may sometimes be due to the need to obtain foreign currency, and in other cases it is because of the limited capacity of domestic markets to absorb relatively large placements. At the same time by issuing debt securities on international markets, national governments raise funds while not investing or investing insignificant amounts across borders. The results of their operations are shown in Table A2 in the Appendix. It shows that during this period the governments of the countries under review received a net $36 bil. in market funding from international markets. This, in turn, implies that the private sector has invested in international capital markets for purchasing financial assets an amount of money of over $111 bil.

The overall dynamics of portfolio investment shows that over the period under review there has been a clear tendency for capital outflows to exceed inflows in the EU Member States

[12] Under pressure from the European Commission, Cyprus terminated the Program after 1 November 2020, but despite this, a version of the Program continues to exist. In 2023, applicants obtain a permanent residence permit in Cyprus by investing at least €300,000 in real estate or securities and showing an annual income of €50,000. If the applicant invests in residential property, his/her income must come entirely from abroad. If he chooses other investment options, his total income or part of it may also be from Cyprus.

from Southeast Europe, which has become particularly evident in recent years, post-2018. The net effect in 2014-2022 is that the volume of financial outflows from these countries exceeds inflows by over $75 bil., which is about 9.4% of the total GDP for 2022 of all these countries combined.

Over the period under review, Bulgaria, Croatia, and Greece have net financial outflows of $8.5 bil., $5.2 bil., and $116.3 bil. respectively, or a total of $130 bil. At the same time, Cyprus and Romania managed to attract larger financial inflows than outflows. For them, net inflows were $16.1 bil. and $38.9 bil., respectively, or $55 bil. in total. But if one isolates the operations of governments, the result is that Bulgaria, Croatia, Greece, and Romania would have net outflows of capital for $14.1 bil., $5.3 bil., $91.1 bil. and $4.8 bil. respectively or $115.3 bil. in total. Only Cyprus manages to attract an inflow amount larger than the the outflow amount – the net inflow is in the amount of $4.3 bil. But as already highlighted, this is due to the exceptionally large inflow of equity investment into Cyprus in 2018 ($8.3 bil.). If this year's inflow were at the level of the average volumes over the whole period ($1.3 bil.), Cyprus would also have a net outflow of capital.

In general the data shows that there is a substantial financial outflow from the region through the capital markets. For the period under review, the net outflow was $75 bil., and if debt issuance by governments is not considered, the net outflow is $111.1 bil. Thus, it can be argued that financial resources that could develop the "catching up" economies from the periphery of the European Union are invested abroad and support already developed economies, mostly in the Eurozone.

The process of capital outflow of this magnitude is clearly unfavourable for the economies in question, given the links between economic development and the degree of financial intermediation. This is a source of concern because well-functioning capital markets are important for economic development. They provide market financing for funding firms and public institutions. Economic entities can also be financed by banks, but it must be emphasized that the financing from capital markets is fundamentally different in its functions from the funding provided by bank financing. Both banks and capital markets provide financial intermediation, but these two sources of finance have different functions in the financial system, which complement each other. Capital markets can mobilize "long-term money", support a range of projects that could not rely on bank financing and thus they contribute to economic growth. Moreover, they are associated with business risk sharing in the private sector, as well as sharing the benefits of economic development, which in turn contributes to the stability of the economic system.

3. Portfolio investment and the economic and business environment

The tendency of consistent net outflows of portfolio investment by countries in the SEE region is not favourable for them, as we have already mentioned. But what are the reasons behind such a process? The stability of this tendency and the relatively large volumes of capital outflows point to fundamental, underlying reasons. What might these be?

The countries under review can be considered as similar, according to several of their characteristics, but at the same time there are many differences between them. The common features can be sought in terms of geographical location, the "catching up" nature of their economies, the strong dependence on economic processes in the euro area and the negative impact of the 2008 global financial and economic crisis, both in terms of foreign trade and investment activity. Meanwhile, countries differ in a range of key characteristics. Bulgaria, Romania, and Croatia are relatively recent EU members, while Greece and Cyprus are older

Member States[13]. The first group of countries has gone through a transition from central planning to a market economy with the inevitable crises and institutional problems of such a fundamental transformation, while Greece and Cyprus have not experienced such problems. During the period under review, Romania and Croatia maintain a floating exchange rate[14], Greece and Cyprus are members of the euro area, and the Bulgarian economy operates under a Currency Board arrangement.

Various factors may influence the interest of portfolio investors. Some of them are related to the macroeconomic environment and the functioning of the economies. Countries characterized by high economic growth and a stable macroeconomic environment attract more portfolio investment, ceteris paribus. Political stability, which is closely linked to economic stability, is also essential.

From this point of view, the countries of Southeastern Europe are not in a less favourable position than other countries in the European Union. Political stability is at a comparable level and macroeconomic stability seems to have been achieved for the period under review, following the European debt crisis. Moreover, the real economic growth rates of the countries under consideration for the same period systematically exceed the growth rates of the Member States in the euro area. There are exceptions only for some years in Greece, which in the beginning of the period under review implemented a highly restrictive policy because of the bailout programs of the European Union and the International Monetary Fund.

The macroeconomic environment is also determined by tax policy. However, the considered countries have an advantage in this respect, as well. Tax rates are difficult to compare because of a variety of possible exemptions, deductions and tax brackets that are strictly local. However, it can be said that the tax rates in the countries under consideration are lower – the capital gains tax rate for trading on regulated markets for them ranges between 0 and 20%, while for countries with large capital markets it is significantly higher[15].

Exchange rate stability as part of macroeconomic stability is also an important factor for foreign portfolio investors. Currency fluctuations can increase investment risks and undermine returns. For this reason, investors generally prefer countries with stable exchange rate regimes or well-managed floating exchange rates. However, for the countries under review the exchange rates are unlikely to have much influence on the decisions of portfolio investors. The reason is that Greece and Cyprus are in the euro area, and the Bulgarian lev has a fixed exchange rate to the euro. The exchange rate of the Croatian kuna (HRK) is floating, but it fluctuates within very narrow limits, compared to the euro. For the entire nine-year period, the lowest value of the Croatian kuna against the euro was in February 2015 (7.68 HRK/€) and the highest value was in June 2018 (7.38 HRK/€). Only the Romanian lei (RON) has a clear trend to depreciate against the euro in the considered period, but the depreciation is very smooth – for the whole period, the exchange rate depreciates from 4.47 RON/€ to 4.94 RON/€. Fluctuations in exchange rates of such magnitude as in Croatia and Romania cannot significantly influence the decisions of portfolio investors.

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[13] Bulgaria and Romania have been members since 2007, Croatia since 2013 and Greece and Cyprus since 1981 and 2004 respectively.

[14] Croatia joins the euro area on 1.01.2023.

[15] Capital gains tax rates for individuals is 0% in Bulgaria, 10% in Croatia, 20% in Cyprus, 15% in Greece, and 1-3% in Romania. Same tax rates for the countries with the largest capital markets in the EU, where most portfolio investments are channaled, are as follows: Germany (25%+5%), France (30%+4%), Italy (26%). Data is from Tax Foundation https://taxfoundation.org/data/all/eu/capital-gains-tax-rates-in-europe-2022.

Given the countries' advantages in terms of economic growth and capital gains tax rates, as well as their relative political and macroeconomic stability, it can be expected that they should have net inflows of portfolio investment, especially from equity financial instruments. For the entire period, there was indeed a net equity inflow of $10.8 bil. (Appendix Table A3). However, as already discussed in Section 2, if the atypically large volumes of investment in 2014 in Greece and in 2018 in Cyprus are corrected and replaced by the average for these countries, the result is reversed. With such a treatment of the data, equity investments in total for the region for the whole period would show a net outflow of $15.9 bil. Apart from Greece and Cyprus, the remaining countries have net equity outflows. If only the last years of the period (after 2018) are considered, then the net outflow of equity investments amounts at $10.1 bil, and for each of the countries considered, the outflow of capital is greater than the inflow.

As the facts show, the expected tendency of inflow of equity investments in the form of portfolio investments is not realized, on the contrary, this type of investment tends to flow out of the region. Obviously, the impact of such factors as macroeconomic and political stability and economic growth is suppressed by other factors.

When it comes to investments in fixed income assets, the most important factor for them is nominal interest rates, which are typically the first consideration for investors when assessing the potential returns of fixed income securities. Higher nominal interest rates generally attract investors as they offer the potential for higher income and returns on their investments. Conversely, lower nominal interest rates may be less attractive as they result in reduced income generation.

To assess the impact of these factors, Table 1 shows the interest spreads of long-term interest rates over German interest rates[16] for each of the countries under consideration. It also shows the credit ratings of individual countries, according to the credit rating agency Standard & Poor's.

Table 1. Interest Rates Spreads (p.p.) and Credit Ratings for Selected Countries

Interest Rates Spreads	2014	2015	2016	2017	2018	2019	2020	2021	2022
Bulgaria	2,37	1,88	1,55	0,72	0,53	0,48	0,81	0,82	-0,24
Croatia	2,93	3,37	2,70	2,17	1,85	0,89	1,25	0,76	1,28
Cyprus	5,41	3,32	3,30	1,28	2,15	0,87	0,81	1,02	2,12
Greece	7,83	7,66	6,69	4,14	4,09	1,72	1,25	1,67	2,14
Romania	3,09	3,07	3,48	4,10	4,41	4,87	3,56	5,75	5,09
Credit Ratings									
Bulgaria	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB
Croatia	BB	BB	BB	BB	BB	BB	BB	BB	BB
Cyprus	B	B	BB-	BB-	BB	BB	BB	BB	BB
Greece	CCC	CCC-	B-	B	B+	BB-	BB-	BB	BB
Romania	BBB-	BBB-	BBB-	BBB-	BBB	BBB	BBB	BBB	BBB

Data Source: European Central Bank, Standard and Poor's Global Ratings

[16] Long-term interest rate for convergence purposes – Debt security issued, 10 years maturity, New business coverage, denominated in euro.

As can be seen from the table, the countries under consideration have relatively high interest rates. Bulgaria and Romania are maintaining an investment grade throughout the period, while the other three countries have a speculative grade. Regardless of the speculative grade of Cyprus, Croatia and Greece and the close spreads (for Greece after 2018), the three countries perform differently in terms of capital flows. Cyprus has managed to attract net investments for fixed income securities, while Croatia and Greece are also attracting, but their investors are buying more foreign assets, so their capital is net flowing out. This shows that other factors than interest rates and creditworthiness impact investor decisions.

For three of the five countries (Bulgaria, Croatia, and Greece) there is a net capital outflow through fixed income securities, and for Cyprus and Romania there is a net capital inflow. In total, $85.9 bil. flowed out of the region. However, if the operations of the respective debt-issuing governments are neglected (see Table A2 in the Appendix), financial flows for both Cyprus and Romania would also show a net capital outflow of $2.5 bil. And $0.4 bil. Respectively. Once again, we see that regardless of interest rates and the creditworthiness of the countries under review, the tendency is capital to flow out based on fixed income securities. Cyprus and Romania managed to compensate for this tendency by accumulating public debt, but for the other countries, even capital raising through government bond issues could not compensate for capital outflows.

The presented arguments show that the trend of capital outflow from South-Eastern Europe, through portfolio investments, cannot be explained by purely economic factors such as economic growth and macroeconomic environment. But there are two other sets of factors which could explain the tendency for capital to flow out. One group includes factors that characterize the investment environment in general - the rule of law, the quality of institutions, the effectiveness of government, corruption, and the size of the shadow economy. These characteristics are not precisely measurable, they are subject to interpretation and there may be different assessments regarding them. But there is no doubt that investors consider them, and they play a significant role in investment decisions. Investors logically prefer countries with effective administration, just and enforceable laws, protection of property rights, less corruption, and less shadow economy.

From this point of view, the countries under consideration are significantly inferior to developed capital markets. To illustrate, Figure 3 shows the ratings of the countries under consideration for government effectiveness and the rule of law, according to reputable international institutions[17]. These estimates are compared with analogous estimates for three countries with developed capital markets in EU member states where a large volume of portfolio investment is concentrated – France, Germany, and Ireland, as well as the average estimates for the euro area. The differences in favour of developed markets in terms of these characteristics are evident. Government effectiveness and rule of law scores for the countries under review are significantly below those of countries with developed capital markets. Besides, their performance is the same for other characteristics that ultimately shape the overall business environment. A similar situation can be observed with respect to important

[17] Government effectiveness data are from the World Bank Worldwide Governance Indicators database. Rule of law data is from the World Justice Project: (https://www.worldjusticeproject.org/rule-of-law-index/)

for the business characteristics like quality of institutions[18], corruption control[19], and the size of the shadow economy[20].

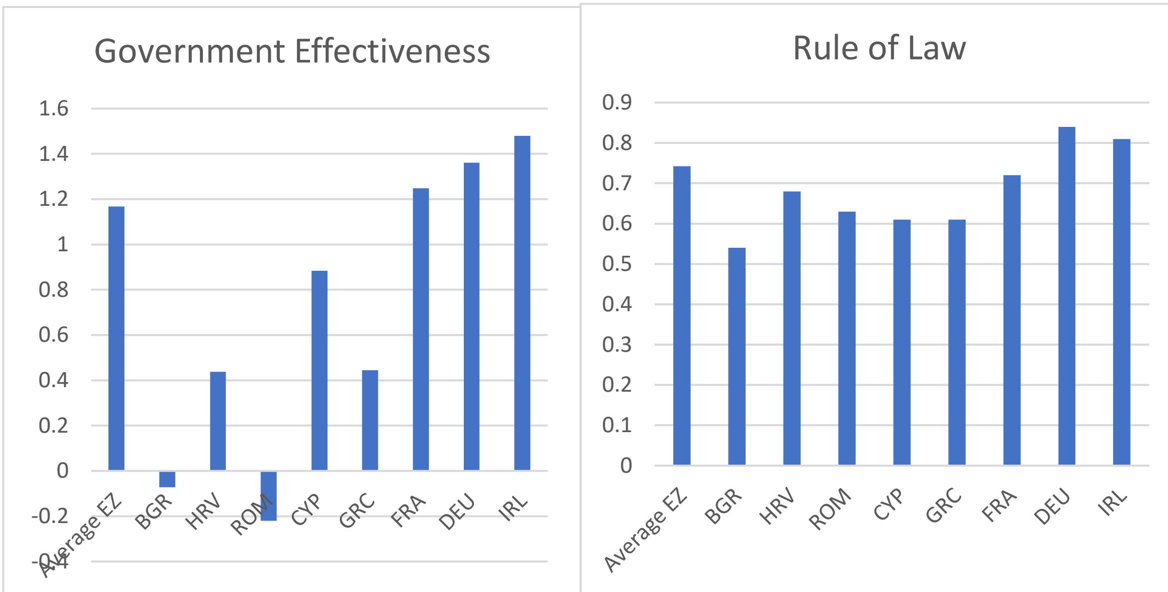

Fig. 3 Government effectiveness and rule of law in selected countries
Data source: The World Bank, World justice project

Compared to the other characteristics a less analysed issue is the extent to which the described processes for the capital flows also depend on the shadow economy in the countries under consideration. The phenomenon of the shadow economy has been studied by many economists and there is extensive literature in this area of research, but the relationship with financial intermediation and capital flows remains isolated.

The damage that the shadow economy does to public finances has been a primary focus of research (Kanniainen, Pääkkönen & Schneider, 2004). Although this is logical and indisputable, recently some authors have also focused on a broader range of effects related to adverse consequences for economic and social development. Some of the latest advances in this direction have been put forward by Hoinaru et al. (2020) and Baklouti & Boujelbene (2020) in terms of the relationship between the shadow economy and such phenomena as corruption and the state of the economic environment, which are also directly linked to the dynamics of capital flows. Other authors have also explored the links with socio-economic progress (Enste, 2018) and (Williams & Schneider, 2016) which serve as a reference for considering shadow economy practices as a complex phenomenon with multidirectional effects, including on investment activity[21].

[18] The statement is based on the value of the indicator Institutional Quality Index, published by the Research Center for Public Policy Libertad y Progreso.
[19] The statement is based on the values of the indicator Government Effectiveness, which can be found in the Worldwide Governance Indicators database, The World Bank.
[20] The countries considered are among those that have the largest size of shadow economy in the European Union (see Kelmanson et al. (2019) or Petranov et al. (2022b)).
[21] The relationship between the size of the shadow economy and investment and through it with economic development is explored in Petranov et al. (2022a).

The other group of factors, which also has significant relevance for investment decisions, relates to the characteristics of domestic financial markets in terms of size, development, and corporate governance practices. Bigger markets with a growing pool of money and demand are generally more attractive to investors. On the other hand, well-developed financial markets with strong infrastructure, liquidity and transparency are more likely to attract FPI. Deep and efficient stock, bond and derivatives markets provide investors with a range of investment options and liquidity to buy and sell their holdings of financial instruments. Finally, the regulatory framework and especially corporate governance practices, including transparency in financial reporting, disclosure standards and minority shareholder protection, are also of great importance.

The status of the countries under consideration in terms of the last group of factors can be understood from Table 2. It shows the size of market capitalization as well as estimates of the level of the legal framework and market infrastructure. As the table shows, the markets' performance in the countries under consideration are lagging significantly behind the developed financial centres. The difference is smaller only in terms of the legal framework, which is a result of the harmonization of the legislation in the EU.

Table 2. Indicators of capital market development in selected countries

	BGR	HRV	ROM	CYP	GRC	FRA	DEU	US
Market Capitalization (% of GDP)[22]	25.6	39.7	10.3	19.7	26.5	84.9	60.0	97.2
Legal Framework[23]	60.5	73.7	90.4	91.5	87.6	95.7	98.0	97.2
Market Infrastructure[24]	52.0	56.0	58.0	58.0	69.0	100	100	100

Data Source: The World Bank, OECD

A review of the factors affecting portfolio investors' decisions, and hence FPI flows, shows unambiguously that the problems lie in the latter two sets of factors – the general business environment and the characteristics of local capital markets. Despite the differences in interest rates and exchange rates, and in the monetary and fiscal policies conducted, it is the relatively worse (relative to developed financial centres) business environment and inferior capital markets characteristics that are common to the countries under consideration. It can be argued that these are the factors that are common to all the countries under consideration which give rise to the tendency of capital outflow through the trading of financial assets.

4. Will the tendency persist?

In the previous sections, we argue that there is a tendency for relatively large capital flows to flow out of the countries under consideration in the form of portfolio investments. There

[22] Total market capitalization of all domestic publicly traded companies in the country, according to data from the World Bank for 2020.

[23] The index encompasses four equally weighted components: accounting and reporting standards; the legal environment underpinning financial transactions; membership of global standard-setting authorities; and the rule of law and the soundness of the regulatory environment. OECD, Transition Report 2021-2022, Chapter 5, THE FINANCIAL MARKET DEVELOPMENT INDEX.

[24] The index captures the reliability of clearing and settlement infrastructure, as well as services provided by central securities depositories (CSDs) and central clearing counterparties (CCPs). OECD, Transition Report 2021-2022, Chapter 5, THE FINANCIAL MARKET DEVELOPMENT INDEX.

are many reasons for this pattern. On the one hand, experience has been gained in developed capital markets, new opportunities are more quickly absorbed there, confidence in them is higher, investment products are more numerous and more diverse, new financial technologies are adopted faster. This creates the conditions for attracting investors and capital market participants in the countries under review have benefited from the expanded opportunities of free capital movement within the EU. This is executed through numerous channels, both direct and indirect. Indirect channels include private pension funds and collective investment schemes, most of which are "feeder fund" structures of foreign asset management companies, while direct channels include the distribution of foreign financial products through the domestic branch network of foreign banks and through various investment intermediaries, as well as direct investing through personal brokerage accounts.

On the other hand, capital markets in the countries under review have been operating relatively recently (even in older member states such as Greece and Cyprus), they are characterized by low liquidity and small size and the overall investment environment in the period under review is perceived by foreign investors as unfavourable due to inefficient governance, and rule of law issues. Also, the corporate governance practices of public companies, investor protection and dividend policy in many cases do not meet high standards. Given that there is freedom of movement of capital within the EU, all this creates conditions for domestic investors (individual and institutional) to channel their funds to developed markets, while domestic markets remain relatively unattractive for both foreign and domestic investors. As argued in Section 2, this situation is not favourable for the countries under review because it deprives local economies of financial resources and the benefits that well-functioning capital markets can bring.

As a result, two logical questions arise. The first is how sustainable is this state. Given the factors that determine it, we believe that it will persist and prove sustainable. The analysis in the preceding sections suggests that the main problems are linked to the business environment (broadly) and the size and quality characteristics of local capital markets. These factors cannot change quickly or easily, and they are likely to persist for a relatively long time, i.e., the trend of capital flight in the form of portfolio investment is likely to continue for some period. Such an opinion is in line with other empirical studies, which find that the financial infrastructure, information flow, and regulatory stability contribute to the concentration of portfolio investments in large financial centers. See for example Kacperczyk & Schnabl (2013) and Forbes (2005).

The second logical question is whether change can occur in the long term. One possibility lies in the European Commission's 2015 initiative to build the so-called Capital Markets Union (CMU). At the core of this initiative is the understanding that the financing of the European economy is too dependent on the banking system and there is a need to increase the share of market-based financing. The result is a Plan which, by design, should lead to a single market for capital. The ultimate strategic objective is that this market should channel financial resources (investments and savings) in such a way that they are available to the whole EU, i.e., they can be used by consumers, investors, and companies wherever they are. Ideally, with fully integrated local capital markets in different countries, assets with identical risk characteristics would have the same price regardless of the country in which they are traded. Moreover, the free circulation of financial flows ensures that the risk assets concerned have the same expected return, regardless of their location.

Short-term priorities to achieve the strategic goal include facilitating the raising of capital and increasing cross-border investment, with a focus on small and medium-sized enterprises;

establishing pan-European private placement procedures for the issuance of various financial instruments to stimulate direct investment in small enterprises; and supporting the creation of new long-term investment funds to redirect investment towards infrastructure and other long-term projects.

In the second half of 2020, the EC reported on the results achieved and adopted a New Action Plan reaffirming the strategic objective of the original Plan, which essentially means a better balance between bank and market funding, easier access for firms to market funding, removing barriers to cross-border investment, promoting long-term investment, integration of national capital markets. In addition, the New Plan also includes proposals to support green and digital economic recovery through more accessible financing for European companies, as well as tax relief for cross-border investment, the development of cross-border settlement, the unification of supervisory practices and the improvement of investor protection.

The New CMU Plan is currently under implementation and some of the measures proposed have already been implemented, others are still to come. Conceptually, the initiative to create such a union could have a positive effect on the economies of the countries under review.

The reason is that many of the actions in the Plan are primarily aimed at improving, in various ways, access to finance for small and medium-sized enterprises, start-ups and innovative businesses, as well as accumulating funds for building infrastructure and other long-term projects. These areas are particularly important for the economies of the countries concerned because they are difficult to finance from the banking system.

However, certain risks must also be considered. The measures envisaged in the plan, such as standardization, new investment products, liberalization, expanded opportunities for cross-border investment and others, undoubtedly stimulate capital flows. This may provide more opportunities to finance the growth of the economies of the countries under consideration in case financial flows from countries with large savings and large financial resources are directed to small and medium-sized enterprises or infrastructure in the region. But there is another possibility – savings from the region may flow out and be invested in other countries, stimulating the growth of other economies. Judging by the financial flows for the period under review, the second option is more likely to materialize so far.

The coin has two sides. Easing the conditions for capital movements as regards savers and investors has a positive effect. They now have a wide range of investment alternatives to choose from, they have regulatory and technical access to virtually all international markets, and, in some cases, they can benefit from tax breaks. This is a favourable development for this group of market participants, which is particularly true in a period (like the one under consideration) characterized by low and often negative real deposit rates.

From the perspective of issuers, the effect is not so positive. CMU initiatives have eased access to market-based financing for companies in general and for small and medium-sized enterprises in particular. They have widened the scope for entrepreneurs through the regulation of new forms of collective investment, as well. But all these opportunities have so far been exploited to a minimal extent in the region and no significant inflow of portfolio investment has been observed.

Based on the above arguments, we conclude that the tendency of financial outflows through portfolio investments is likely to continue in the short and medium run because the difficulties impeding the development of capital markets in the Southeast European countries under consideration are not few. Markets that are more developed and trusted naturally attract investors and the result is that capital is channeled towards them. This in turn reduces access to financial resources for local companies in the region. Such a trend is not dramatic for the period under review due to the inflow of direct investment and good liquidity of banks (after the debt crisis in the euro area). But this situation may change. If significant funds continue to systematically flow out, this will be a constraint on the region's growth.

The flow of funds to major capital markets cannot be avoided. However, the development of the CMU provides a chance to mitigate to some extent this trend.Such an opinion about the potential of the CMU is shared by other researchers, as well, for example Álvarez Otero(2021). This task requires active work to stimulate the development of local capital markets in such a way that the real sector of the countries in the region takes the benefits from such a Union.

Conclusion

The analyses and arguments presented in this study provide grounds for several summary conclusions. First, the data show that in the years following the European debt crisis, portfolio investors' capital outflows from the EU Member States of Southeastern Europe have significantly exceeded inflows, i.e., there has been a trend of capital flight from the region. This trend is likely to continue in the short to medium term due to weaknesses in the business environment (in general) and underdevelopment of local capital markets. This is disadvantageous for the countries concerned because it makes it more difficult for local firms to access market financing and therefore limits economic growth.

Although undesirable from the perspective of local economies, the outflow of financial flows to developed financial markets cannot be stopped. However, it can be curbed to some extent through proper market-oriented policy measures if the countries in the region can seize the opportunities offered by the European Commission's initiative to build a capital markets union within the EU. The process of building such a Union has been slow and uneven up to now but will continue until it reaches a level similar to the Banking Union.

A Capital Markets Union could in principle be beneficial for the economies concerned if they take measures to develop their domestic markets in a way that is appropriate for them. This would mean improving regulation and market infrastructure, as well as introducing appropriate incentives for market participants. But most importantly, financial instruments should be issued and traded on local markets, leading to easier access to finance for small and medium-sized enterprises, start-ups and innovative firms, infrastructure projects and green projects. These are the areas that are relevant to these countries, and they should stimulate the creation and trading of financing instruments specifically for them. Otherwise, the trend of financial outflows from the countries under consideration will continue and income earned and saved in the countries under review will support not local economies but the growth and the expansion of more developed economies.

From a microeconomic perspective, the presence of large and sustained financial flows from the Southeast European region to major financial centres creates favourable business opportunities for the development of financial services and products. Financial intermediaries that can offer local markets reliable services and competitive prices for asset management or brokerage services are likely to have positive market prospects.

From a macroeconomic perspective, it is important to note that systematic capital flight is not harmless. It can have an impact on a country's balance of payments, exchange rates and ultimately on general economic conditions. In more drastic cases, country's foreign reserves might be depleted and its ability to meet international payment obligations will inevitably be reduced. Governments should therefore monitor and manage these flows to maintain the stability of the economy.

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Appendix

Table A1. Foreign Portfolio Investment in Selected Countries (mil. $, net)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total
Net Outflows										
Bulgaria	416.7	-290.3	870.6	2101.0	1063.5	1697.3	2708.1	2904.4	2275.2	13746.5
Croatia	473.3	146.4	-109.1	515.5	548.2	1332.2	672.5	1363.0	na	4942.0
Cyprus	-2273.5	-489.6	1602.1	3632.8	3676.4	2813.5	148.1	3087.1	1382.9	13579.9
Greece	11098.2	7290.6	7581.7	-23184.4	580.4	27738.4	38761.1	31031.8	10005.1	110903.0
Romania	129.7	330.4	385.5	569.7	493.0	1542.1	42.1	1853.9	1333.6	6680.0
Total Outflows	9844.3	6987.5	10330.8	-16365.5	6361.6	35123.5	42331.9	40240.3	14996.9	149851.4
Net Inflows										
Bulgaria	2064.4	374.8	1672.5	-1156.1	-777.6	-95.5	1895.2	166.5	1077.5	5221.8
Croatia	-453.8	333.1	-1641.1	67.9	-631.1	-157.3	679.2	1469.5	na	-333.6
Cyprus	2170.3	1735.1	5684.7	4748.0	7276.3	-409.5	4688.1	4129.4	-312.8	29709.7
Greece	3014.0	-1572.3	-2870.4	918.0	1804.8	2031.1	-14614.6	4221.7	1652.4	-5415.3
Romania	3901.4	277.4	1423.5	3928.0	3907.5	4255.3	15315.7	6006.3	6605.7	45621.0
Total Inflows	10696.3	1148.1	4269.2	8505.9	11580.0	5624.2	7963.6	15993.5	9022.8	74803.6

Data source: IMF, Balance of Payments

Table A2. General Government Foreign Portfolio Investment in Selected Countries (mil. $, net)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total
Bulgaria	-2099.1	-394.5	-1044.4	980.0	143.8	54.7	-2058.6	-70.0	-1098.2	-5586.3
Croatia	-217.1	-244.2	1483.5	-479.7	611.2	574.6	-896.4	-904.8	0.0	-72.8
Cyprus	-434.2	-1065.3	-960.3	-409.9	-1414.7	-2651.3	-3977.9	-1017.3	85.0	-11845.9
Greece	6727.9	-2188.8	3374.0	1271.9	-1382.0	-1203.5	15048.1	2383.1	1145.1	25175.9
Romania	-3306.3	43.0	-1886.4	-3923.3	-4169.9	-4310.6	-15033.9	-5401.1	-5765.1	-43753.7
Total	671.2	-3849.9	966.3	-2561.0	-6211.6	-7536.0	-6918.6	-5010.2	-5633.1	-36082.8

Data source: IMF, Balance of Payments

Table A3. Foreign Portfolio Investment in Selected Countries by Asset Classes (mil. $, net)

Net Outflows – Equity	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total
Bulgaria	469,5	307,3	78,4	361,1	545,1	-547,6	1077,8	1403,9	784,6	4480,0
Croatia	167,6	191,9	-135,9	402,4	303,1	505,6	409,3	781,1	0,0	2625,0
Cyprus	-109,4	-208,7	566,6	1974,0	1665,4	1068,0	-702,5	2220,4	-1274,2	5199,5
Greece	999,1	7180,7	-2984,5	-1851,8	-997,0	-98,5	585,0	2424,8	149,6	5407,5
Romania	-2,7	204,2	143,4	129,8	-85,2	131,5	503,0	23,8	648,9	1696,7
Sub Total	1524,0	7675,4	-2332,1	1015,5	1431,4	1059,0	1872,5	6853,9	308,9	19408,6
Net Outflows – Debt										
Bulgaria	-52,8	-597,6	792,3	1739,9	518,4	2244,9	1630,2	1500,6	1490,7	9266,5
Croatia	305,7	-45,5	26,8	113,0	245,1	826,7	263,3	582,1	0,0	2317,3
Cyprus	-2164,1	-280,9	1035,5	1658,8	2011,0	1745,6	850,7	866,7	2657,2	8380,5
Greece	10099,1	109,9	10566,3	-21332,7	1577,4	27836,9	38176,1	28607,1	9855,5	105495,5
Romania	133,0	126,0	241,8	440,2	578,4	1410,6	-460,8	1830,3	684,7	4984,1
Sub Total	8320,9	-688,1	12662,6	-17380,8	4930,4	34064,7	40459,5	33386,8	14688,0	130444,0
Net Inflows – Equity										
Bulgaria	-76,6	-28,6	-34,6	-110,4	48,8	-90,9	-165,4	-107,1	24,4	-540,4
Croatia	-45,6	10,7	12,9	34,2	13,4	-27,1	-147,1	-9,4	0,0	-158,1
Cyprus	1552,4	1193,4	741,6	-443,9	8314,2	-59,7	-138,9	1334,3	-509,1	11984,2
Greece	11266,4	7002,1	553,9	494,5	-173,3	-43,8	-690,8	2469,4	72,1	20950,4
Romania	534,8	361,7	-459,4	-61,1	-479,3	-656,1	-854,6	-142,9	-249,7	-2006,6
Sub Total	13231,4	8539,2	814,4	-86,7	7723,8	-877,7	-1996,9	3544,4	-662,3	30229,5
Net Inflows – Debt										
Bulgaria	2141,1	403,4	1707,1	-1045,7	-826,4	-4,5	2060,5	273,6	1053,2	5762,2
Croatia	-408,2	322,5	-1654,0	33,4	-644,4	-130,1	826,4	1478,9	0,0	-175,6
Cyprus	642,0	558,9	4943,1	5191,9	-1127,5	-384,7	4827,0	2795,1	196,2	17642,1
Greece	-8252,4	-8574,4	-3424,3	423,5	1978,2	2074,9	-13923,8	1752,3	1580,3	-26365,7
Romania	3366,6	-84,5	1882,9	3989,2	4386,2	4911,5	16170,3	6149,4	6855,4	47627,0
Sub Total	-2511,0	-7374,0	3454,8	8592,4	3766,0	6467,0	9960,5	12449,3	9685,1	44490,1

Data source: IMF, Balance of Payments